IMPACT STUDY:

Venture capital and private equity investors' impact on corporate growth in 2010–2019

KPMG

Pääomasijoittajat

Key observations in the impact study:

- Businesses owned by venture capital and buyout investors, which together are referred to as private equity (PE) investors, are among the fastest growing companies in Finland
- Turnover of PE-backed businesses has grown on average approximately nine times faster than at peer companies
- The number of personnel in companies owned by PE investors has increased on average five times faster than at the peer companies
- Developing business operations and enabling growth require investments – Companies owned by buyout investors have been able to grow and improve their profitability simultaneously

Introduction

Private equity has great significance as an accelerator of economic growth and as an employer in Finland. The aggregate revenue of Finnish portfolio companies owned by both domestic and foreign private equity investors is over 22 billion euros, representing some 5 per cent of the revenue of the Finnish companies in total. The total employee count in the portfolio companies in Finland is approximately 70,000, that is over 5 per cent of the total amount of personnel in all the Finnish companies. In addition, part of the employees - approximately 13,000 – of the Finnish private equity investors' portfolio companies work abroad.

The purpose of this report is to provide an overview of the impact of venture capital and private equity investments on Finnish business activities. The material in the report consists of companies that received an initial investment from a Finnish private equity investor between 2010-2019. The analysis was implemented by KPMG Oy Ab in cooperation with the Finnish Venture Capital Association.

Private equity investment means corporate financing outside the stock exchange, which is often done in the form of equity financing and typically channelled to the marketplace through PE investment funds. Private equity investors manage funds whose largest investors include e.g., employment pension companies and other institutional investors. Investments are, in principle, made for the medium or long term and characterised by active ownership. The holding periods have historically been approximately five years on average.

Active ownership means that the investor engages in close cooperation with the company's management in order to develop its business operations further.

In this report, private equity investment is divided into two categories: Venture Capital (hereinafter "VC") and Buyout (hereinafter "BO"). VC investments are targeted at early-stage companies that need funding and experts to develop and grow the company. In this context, a VC company refers to a company that has received a VC investment. BO investments are often directed at medium-sized companies and are, in terms of their profile, less risky than investments made in VC companies.

Private equity investment provides many benefits, for example, by strengthening the company's financial standing and by bringing new capital to the company, which enables it to make new investments or to find debt financing for growth.

In addition to capital, PE investors provide companies with strategic expertise, develop the reporting and management systems, create modern incentive and commitment models, and make their own contact networks available to the company for rapid development of the operations and recruitments. PE investors enable companies to access new markets through their extensive networks, both at national and international levels.

This report focuses on the impact of private equity investors on three different subject areas in corporate operations: growth of companies, increase in personnel, and profitability.

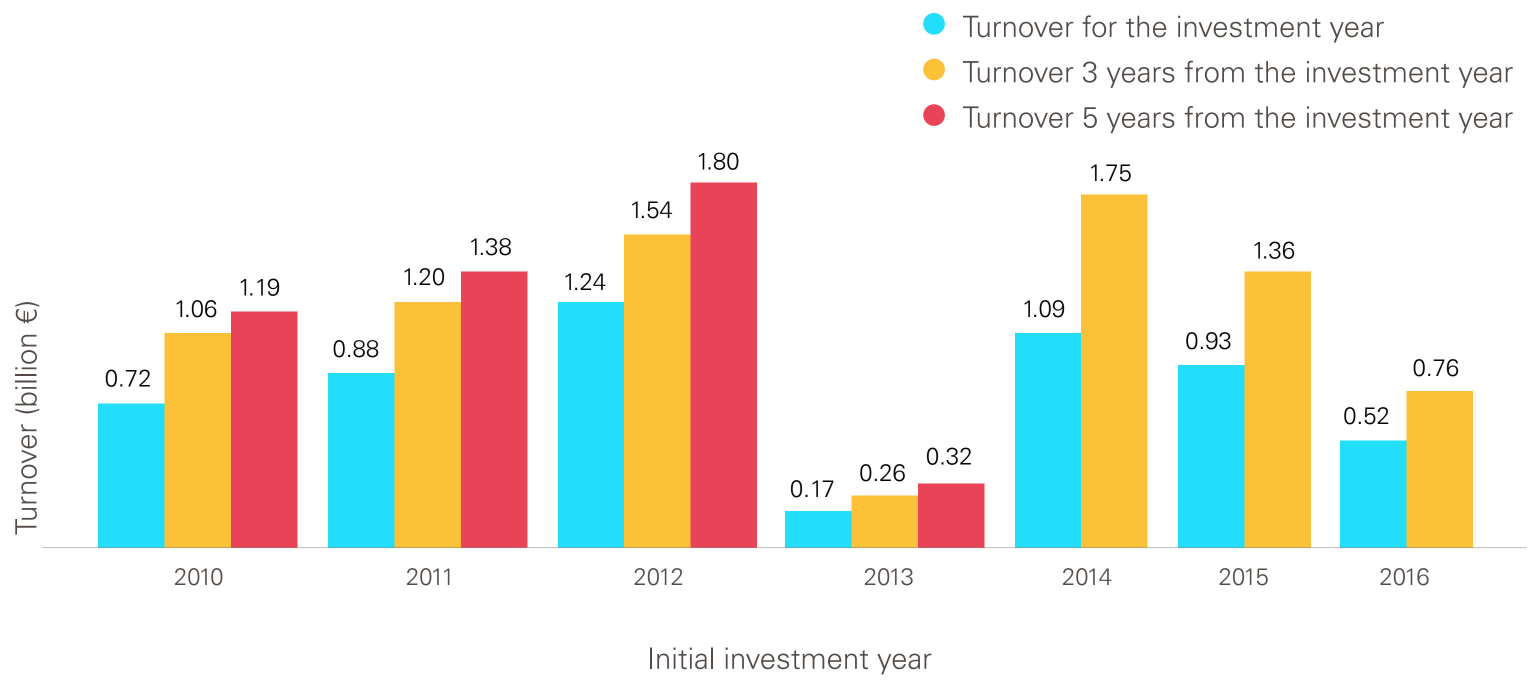
GROWTH:

Businesses owned by venture capital and private equity investors are among the fastest growing companies in Finland

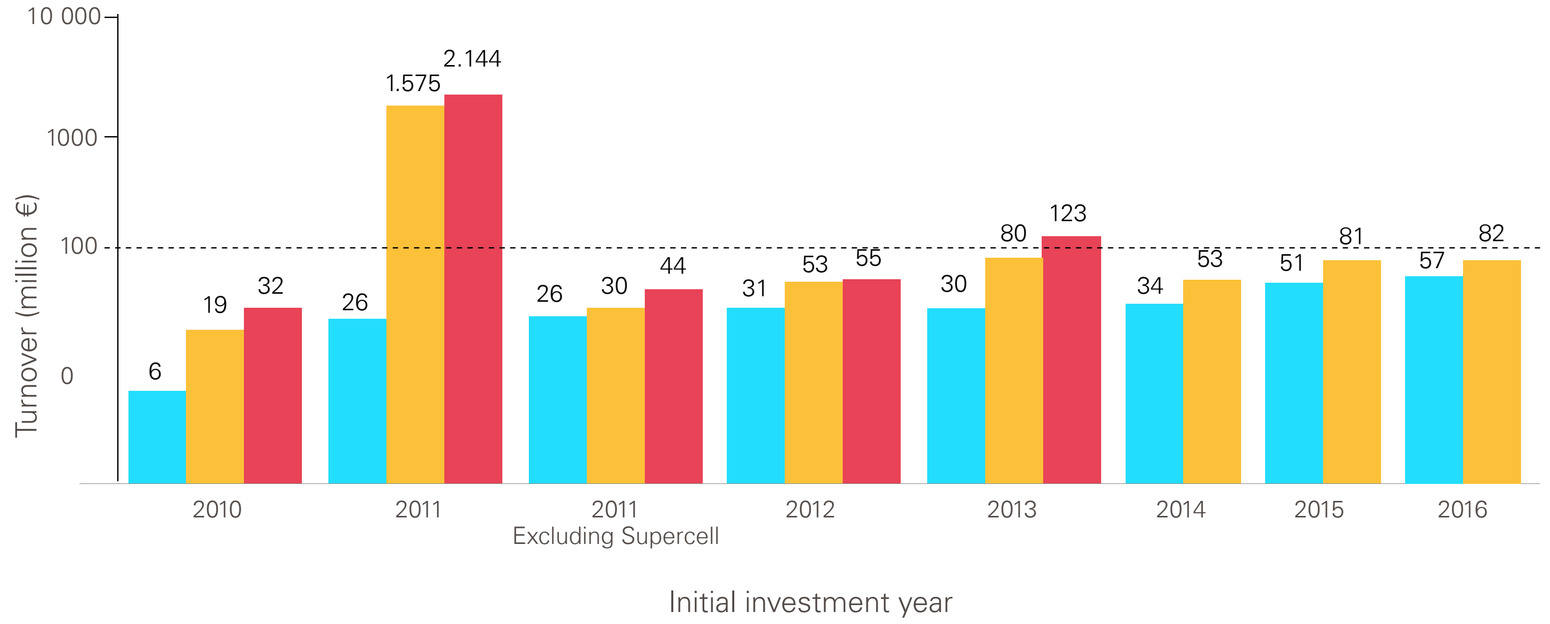
The goal of private equity investors is to generate rapid growth for their target companies by means of development of business operations and through both organic growth and acquisitions. Some of the growth in turnover at such companies comes with acquisitions, but much of the change takes place organically as the companies grow.

Results of the study:

We studied the development of the companies that received their initial investment between 2010 and 2016 over a three-year period as well as a five-year period; e.g. for companies receiving an investment in 2010,



Graph 1. Buyout companies' turnover for the investment year as well as 3 and 5 years from the investment



Graph 2. Venture capital companies' turnover for the investment year as well as 3 and 5 years from the investment

the review extends until 2013 and 2015. During the 2010 to 2016 period, there were 191 BO companies and 245 VC companies that received their initial investment from private equity companies. The five-year investment horizon has been reviewed for companies that have received the initial investment between 2010 and 2013.

The combined turnover of BO companies, shown in graph 1, was €5.6 billion in investment years 2010-2016, whereas the combined turnover three years after the initial investments was €7.9 billion. The combined three-year growth equaling €2.3 billion shows signs of the significant value added that investments by BO companies generate. The growth is generated through investments in development of business operations as well as in organic growth and acquisitions. BO companies that received the initial investment between 2010-2013 generated turnover of €3.0 billion in the investment year, managing to grow to €4.7 billion turnover five years after the investment.

For VC companies, growth has been significant and most of it was generated organically. Graph 2 shows a combined turnover of €261 million from the reported VC companies between 2010-2016. The combined turnover three years after the investment reached approximately €1.9 billion. VC companies aggregated turnover for years 2010-2013 was €119 million increasing to €2.4 billion in five years. These numbers are mostly explained by the rapid growth of Supercell. Supercell reported a turnover of approximately €150 thousand in investment year 2011, whereas the same figure in 2014 was approximately

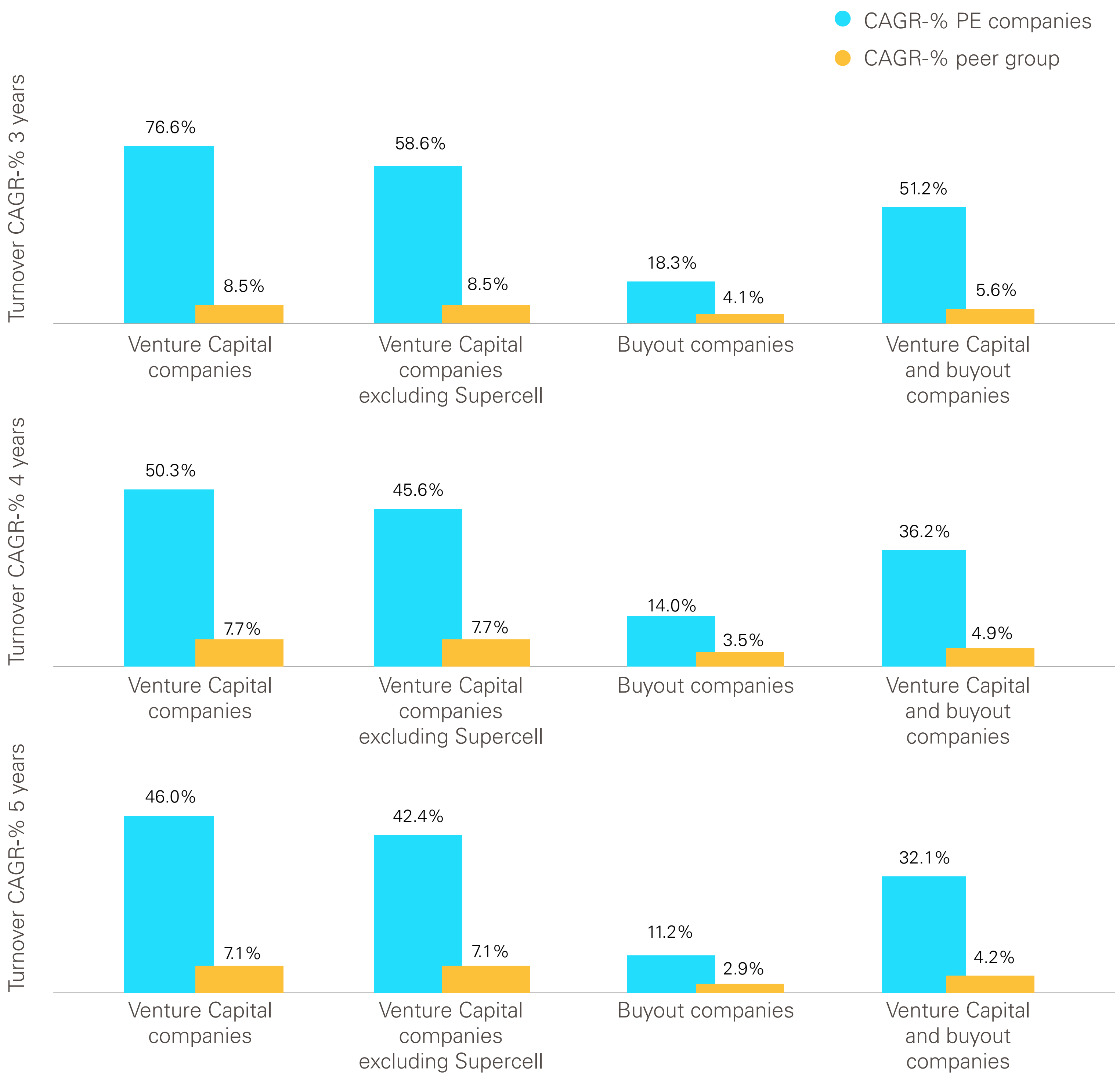
€1.5 billion. Thus, the combined turnover of VC companies three years after the investment excluding Supercell was around €398 million.

Supercell is a good example of the importance of private equity investors as enablers of corporate growth. Where competition intensifies and companies see an increasing need for growth, PE investors act as strategic and financial partners. Although VC investors aim at the highest profits possible by carefully selecting which startups to invest in, an estimated one-half of the companies that receive a VC investment fail to execute their business plan and close down operation within a few years. As an example, in addition to the 245 VC companies (2010-2019) in our study, financial figures for 116 VC companies were unavailable. Our estimate is that, at most, about 10 percent of these 116 companies were part of a successful acquisition. Hence, one can say that since private equity investors seek high profits with their VC investments and look for "the next Supercell", the investment activity involves significant risks. PE investors try to manage their own risks by dividing their investments among several companies, aiming to ensure a positive yield for the fund.

In our study, we wanted to find a comparable group that could be compared with the target companies that received an investment. Therefore, a peer group was created for every combination of an investment type and initial investment year, and the criteria for these are explained in detail in the Methodology paragraph.

The peer group was compared with the target companies by using the compounded annual growth rate (CAGR) figure. CAGR refers to an annual growth rate, so in this section we studied the annual growth rate of turnover and the next section focuses on the annual growth rate of personnel. Said CAGR figures studied for three-, four-, and five-year periods are presented in graph 3. The average three, four, and five-year CAGR of BO companies was reported as 18.3%, 14.0%, and 11.2%. Compared to the peers these numbers are on average four times bigger than the peers.

The development of VC companies compared to the peers was significantly better, both including and excluding Supercell. With a sampling of all the VC companies, the three-, four-, and five-year CAGR was 76.6%, 50.3%, and 46.4% including Supercell. The same numbers excluding Supercell were slightly lower, however, still significantly higher than the peers. CAGR could not be calculated for VC companies that did not show any sales during the investment years. In addition, it is important to notice that the CAGR figures of VC and BO companies are not comparable with one another due to the difference in the companies' size.



Graph 3. Venture capital and buyout companies' 3-, 4- and 5-year average turnover CAGR-% compared to peer group

The combined average three-, four- and five-year CAGR of BO and VC companies were 51.2%, 36.2% and 32.1%, whereas the peer group's corresponding figures were 5.6%, 4.9% and 4.2%. Thus, it can be stated that the annual turnover growth rate of private equity backed companies is 7-9 times higher than the other companies' growth in the industry depending on the length of the review period.

PERSONNEL:

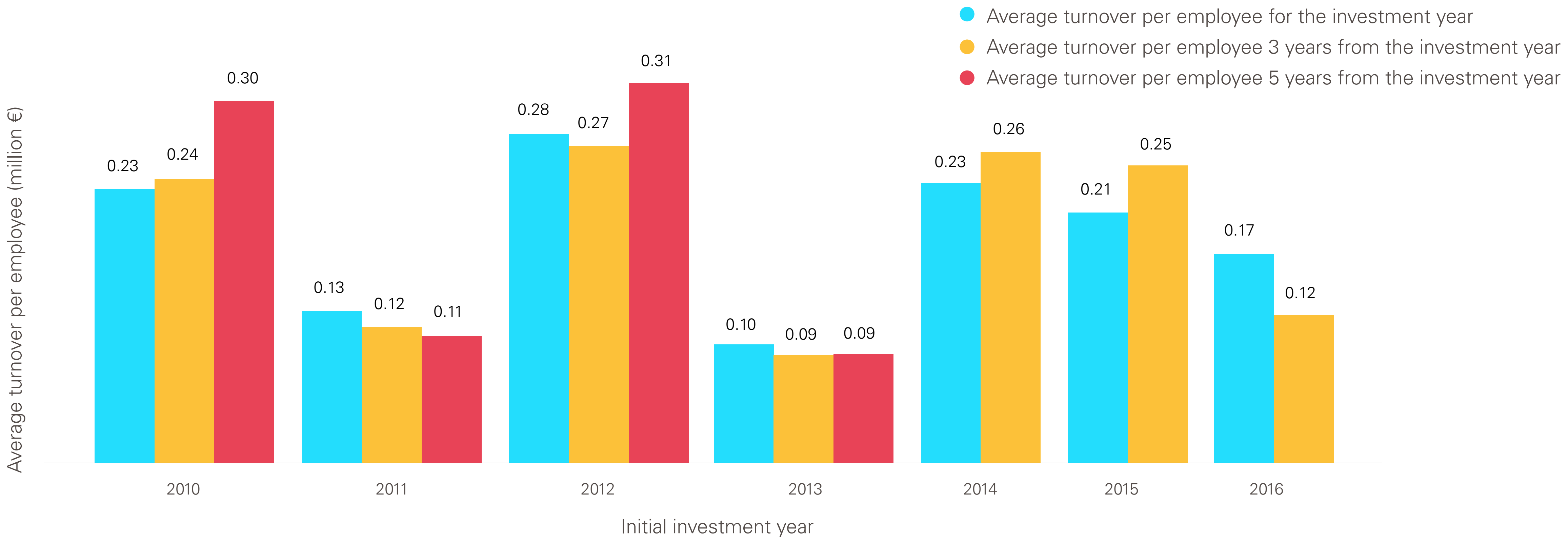
The number of employees in companies that received investment from PE investors has increased on average five times faster than at peer companies

Companies that are funded by private equity can hire more employees in order to enable growth. On the other hand, rapid growth also requires hiring new employees to enable growth in the long-term. This is seen as a positive factor for both such companies and the Finnish economy. Some of the increases in personnel comes with acquisitions, but much of the change takes place organically as the company grows.

Result of the study:

In line with previous studies, we observed that private equity investments increase the number of personnel in the target companies. At VC companies, the combined number of employees at businesses that received their initial investments between 2010-2016 was 2070, while the figure after the three-year period was 3984. This indicates a close to 100% growth when comparing the initial investment year employee count to three years ahead. Our estimate is that almost all the increase in personnel is organic growth, i.e., new jobs created by PE investors through VC investments. Acquisitions have a greater impact on the growth of personnel at BO companies. According to our study, the number of personnel at BO target companies receiving initial investments between 2010-2016 increased from 31 thousand to 42 thousand three years from the initial investment year.

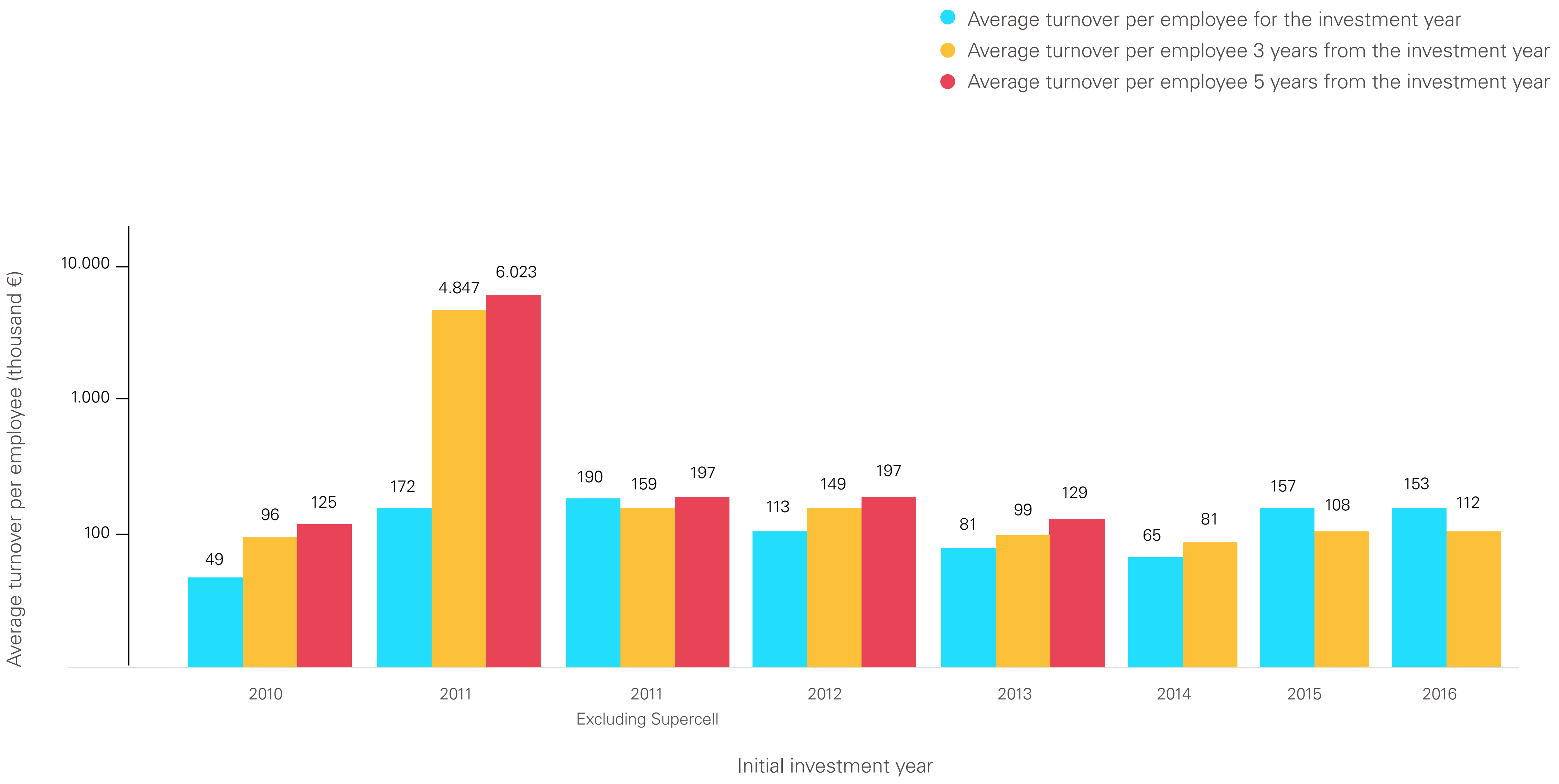
Another indicator that describes the development of a company in relation to staff is the company's average turnover per employee. This relation is also reviewed over a three-, and five-year period from the year of the initial investment. Graph 4 presents these numbers for the BO companies and points out that the average turnover per employee three years from the investment remains similar compared to the figure in the investment year, except for some positive exceptions in the five-year period for investment years 2010 and 2012. This indicates that the number of personnel has to a major extent increased in line with the turnover growth of the companies.



Graph 4. Buyout companies' average turnover per employee – for the investment year and 3 years as well as 5 years from the investment

Graph 5 shows us that VC companies' average turnover per employee on both a three- and a five-year period is growing on a continuous basis compared to the initial investment year. This means that the hiring of employees has in a big picture not been aligned with the company's turnover growth.

This indicator does not tell the whole truth. It is important to remember that many VC investments are based on a scalable business models, meaning that the resources within the invested companies can produce service for growing number of customers. VC companies often have a very low turnover at the time of investment, indicating that an average turnover per employee can easily grow more and significantly faster in comparison with larger BO companies.



Graph 5. Venture capital companies' average turnover per employee – for the investment year as well as 3 years and 5 years from the investment

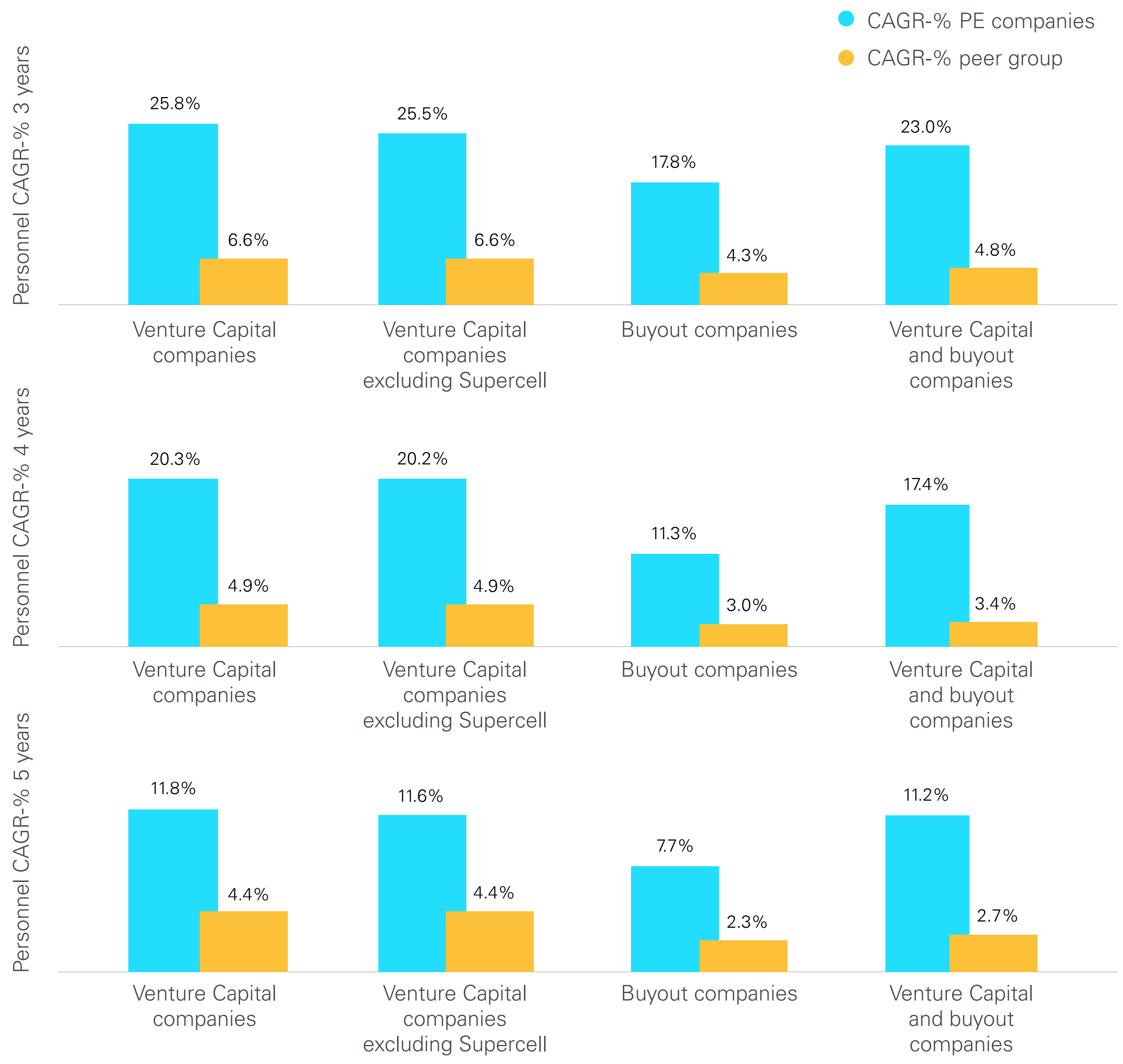
Graph 6 shows the average CAGR personnel growth rates. Within the BO companies the average CAGR-% is much higher than in the peer group. The BO companies' annual growth rates on a three-, four-, and a five-year period were 17.8%, 11.3%, and 7.7% whereas the respective numbers for the peer group were 4.3%, 3.0%, and 2.3%. VC companies show a much higher annual growth rate compared to the peers. The VC companies reported personnel growth within the three-, four- and five-year periods of 25.8%, 20.3%, and 11.8%, with some minor differences when excluding Supercell. The peer group, in contrast, grew by 6.6%, 4.9%, and 4.4%. It is not very surprising that VC companies have a higher growth of personnel than BO companies, given that the increase in employees should naturally be high at relatively small, rapidly growing companies compared to what one would assume in large, mature businesses.

The combined average three-, four-, and five-year CAGR of BO as well as VC companies was 23.0%, 17.4%, and 11.2%, whereas the peer group's corresponding figures were 4.8%, 3.4%, and 2.7%, indicating an approximately five times higher growth rate compared to the peers.

PROFITABILITY:

Developing business operations and enabling growth require investments – Buyout companies have been able to grow and improve their profitability simultaneously

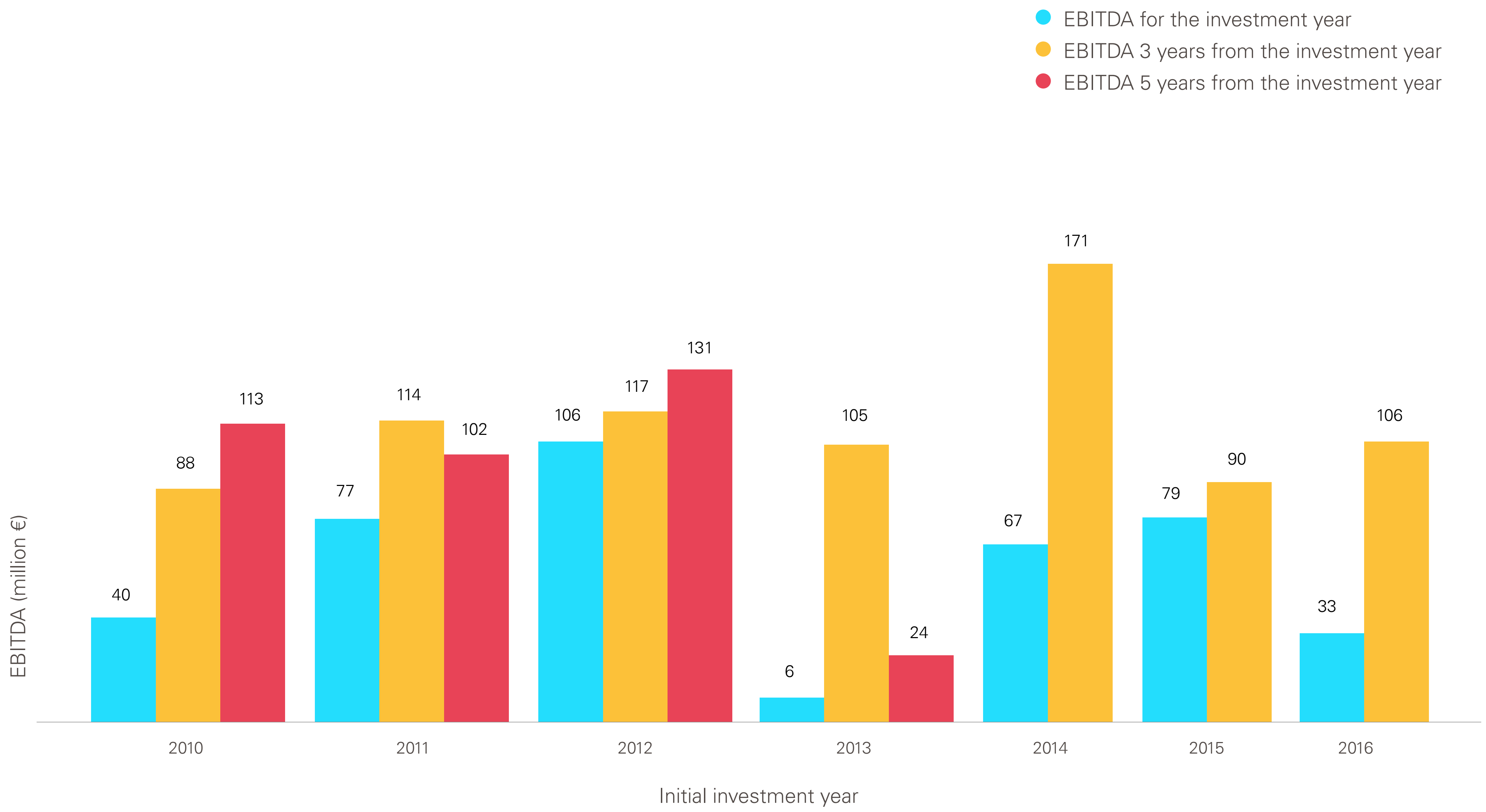
A company can have many motives for seeking external capital, but the main reasons are often the same: the company either seeks growth or needs revitalization or a similar change. Growing a company, revitalizing it and developing its business operations is often expensive; although BO companies have sought rapid growth through investments, they have still managed to improve their profitability.



Graph 6. Venture capital and buyout companies' 3-, 4- and 5-year average personnel CAGR-% compared to peer group

Result of the study:

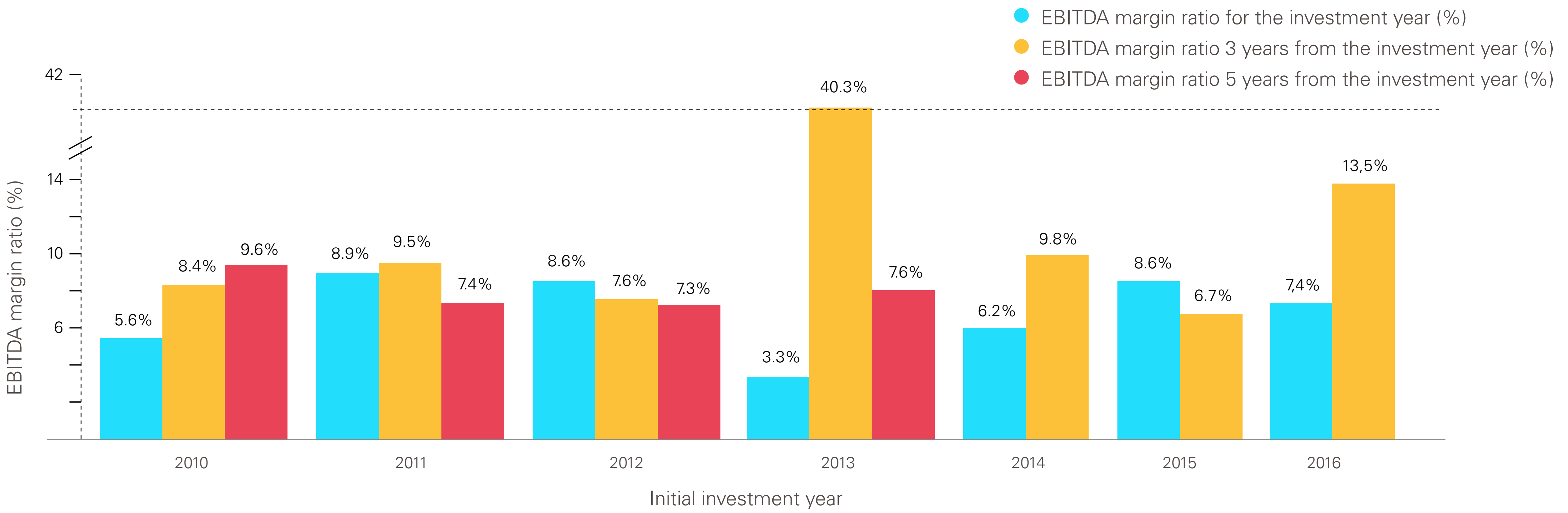
In our study, we used EBITDA as an indicator of the company's profitability. Graph 7 shows the EBITDA of the BO companies. The combined EBITDA from the initial investment year was €408 million between 2010-2016, while after three years from the initial investment, EBITDA reached approximately €791 million. This indicates almost a doubled combined EBITDA during the studied three-year period. Aggregated EBITDA of companies that received the initial investment in 2010-2013 was €229 million, increasing in five years after the investment approximately 62 per cent to €370 million. For years' 2013 and 2014, three years after the investment, the EBITDA figures are extremely high compared to the investment year EBITDA. The reason for the exceptional growth is sale of subsidiaries or business operations of few companies, explaining a significant share of the aggregated EBITDA of the year in question.



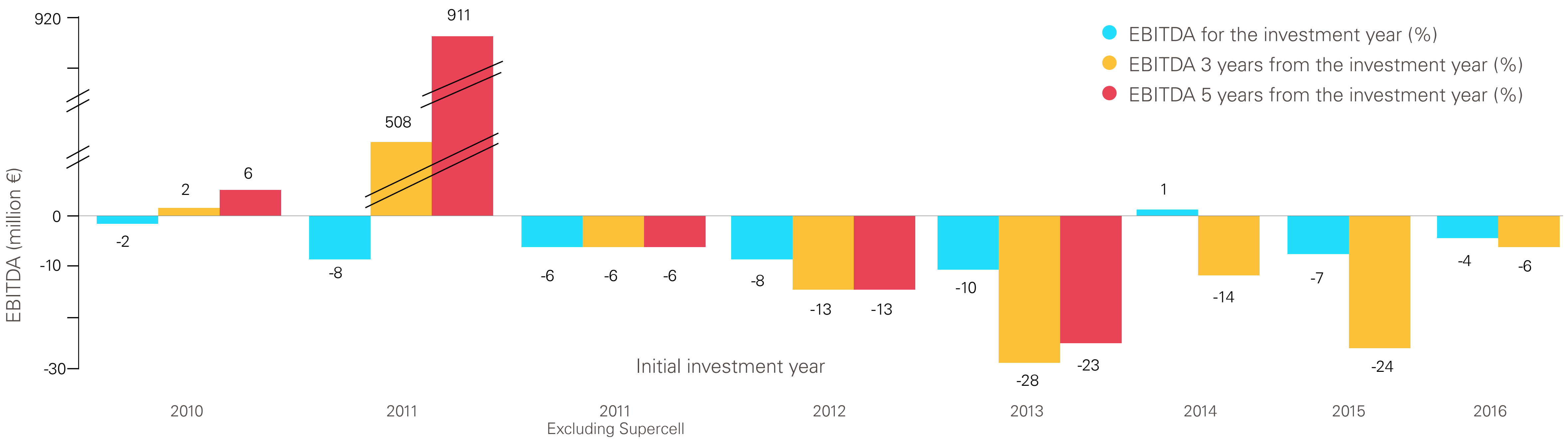
Graph 7. Buyout companies' EBITDA for the investment year and 3 and 5 years from the investment

The absolute EBITDA growth in graph 7 is tremendous, but it should be compared to the companies' growth in turnover. Therefore, the EBITDA margin ratio, calculated as EBITDA in relation to turnover, is presented in graph 8. The graph indicates that even though the companies had a significant growth in turnover (shown in graph 1), the profitability development of the companies has still been positive in most of the review periods. Aggregated EBITDA-margins three years from the investment have improved for five out of seven investment years during the review period. Five years after the initial investment the profitability development has varied slightly more, but still the margins have improved for two out of four investment years, remaining close to the initial level for the two other investment years.

The combined EBITDA for the VC companies in the initial investment years was approximately €39 million negative. Three years after the initial investments for the years 2010-2016 the VC EBITDA stood at roughly €426 million and 5 years after the investment year for the years 2010-2013 at €881 million, of which Supercell accounted for around €508 for the three-year period and €911 million for the five-year period. Graph 9 visualizes this by showing VC companies both including and excluding Supercell. The combined EBITDA for the VC companies excluding Supercell was negative €89 million three years and negative €36 million five years after the investment.

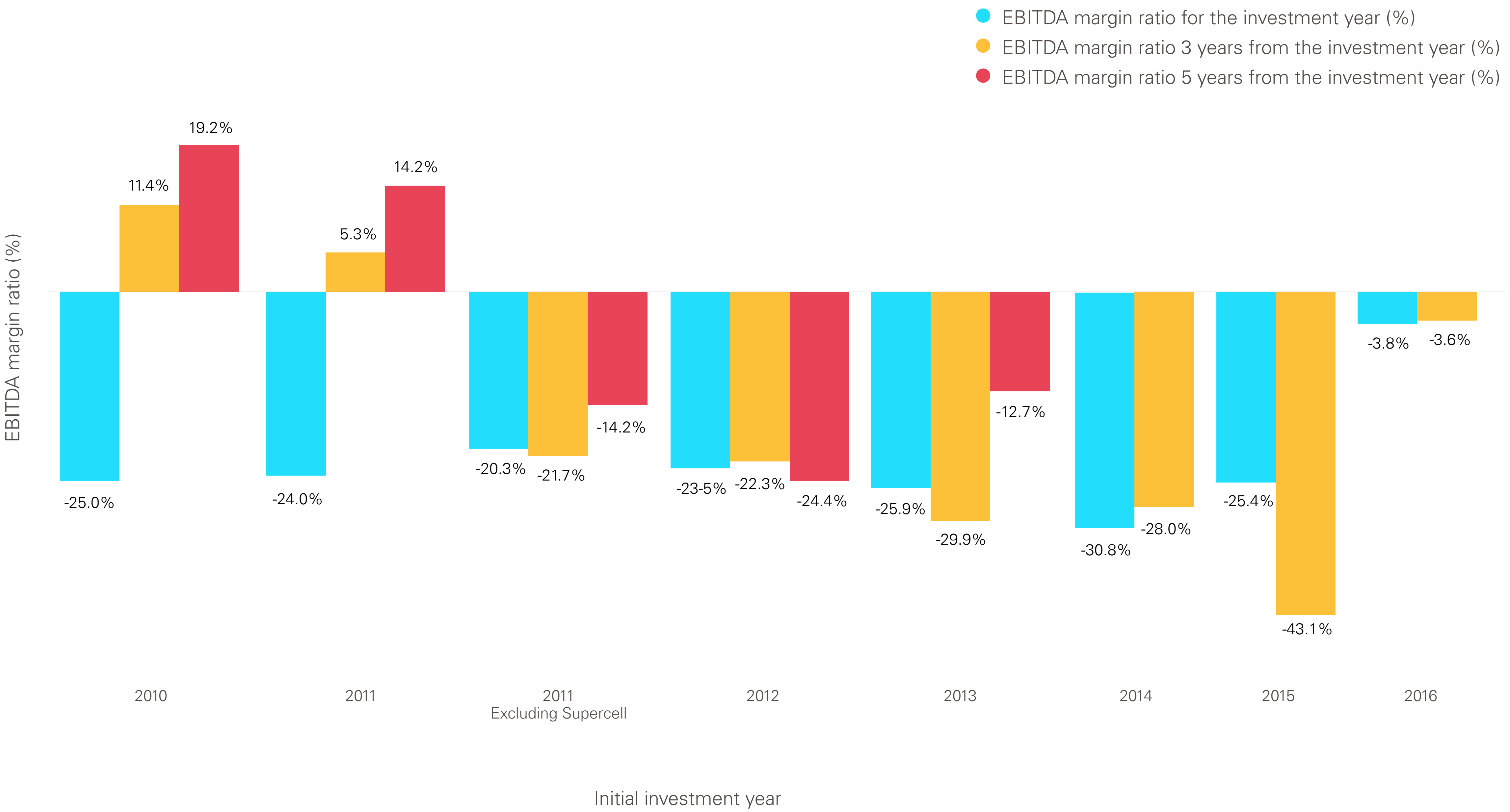


Graph 8. Buyout companies' EBITDA margin ratio for the investment year and 3 and 5 years from the investment



Graph 9. Venture capital companies' EBITDA for the investment year and 3 and 5 years from the investment

Graph 10 illustrates the VC companies' EBITDA margin ratios, that are mainly negative as expected, with few exceptions. However, even though the margins are negative, the companies' turnovers have increased. VC investment targets are usually startups which are unprofitable and hence need funding in order to continue operating and to seek growth. Small companies often look for growth by hiring more employees, using marketing efforts, developing production, etc. These factors are costs that have a direct impact on profitability, as can be seen in graph 9. When a company grows, one can expect profitability to follow. This can be noted by viewing the successful, profitable growth of BO companies and Supercell. Reaching a positive result takes usually longer time for VC-investments namely because of the strong focus on the growth. Positive development in the profitability can however be seen also in the graph 10, even though the EBITDA-margins would be negative 3 and 5 years from the investment.



Graph 10. Venture capital companies' EBITDA margin ratio for the investment year and 3 and 5 years from the investment

Methodology, framework, and constraints of the study

The premise for this study is annual data provided by Finnish private equity investors of their investments in 2010-2019. The sample in the 2010-2019 period comprised 712 target companies, of which 580 could be included in the study based on the availability of their financial figures. Of these 580 companies, 269 were in the BO category and 311 in the VC category.

In our study, we wanted to find a comparable group that could be compared with target companies that received an investment. Thus, a peer group was created for every combination of investment type and initial investment year, in accordance with the following criteria:

- The peer database includes 79 000 businesses with a turnover of more than €100 thousand in 2016.
- For every combination of investment type and initial investment year, all companies are selected from the database in the same industries with turnover between the turnover of the smallest and largest company receiving a PE investment.
- Deleted from the peers are the 0.5% fastest growing companies and 0.5% of the most decreased companies, due to potentially incomparable financial details.
- A weighted average is calculated of the turnover growth rates, by industry, in the same proportion as the target companies' turnover is divided among the industries.

Summary of the report

The findings indicate that private equity investors have a positive impact on their portfolio companies. The turnover and number of personnel at companies owned by PE investors have grown much more in comparison with the peer group. Furthermore, the profitability of BO companies has increased significantly. VC companies require significant investments in growth, so profitability is not manifested in a three-year period but can be expected to improve later on.

Private equity investors contribute managed risk-taking and competence in growing business operations to their companies. This cooperation results in startup companies that succeed in the global marketplace as well as strong domestic and international small and medium-sized companies. This enhances growth and employment in Finland.

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